

Developing a Withdrawal Strategy for Your Fund Portfolio

By John Markese

There comes a time when all that retirement money you have socked away in IRA, 401(k) and 403(b) accounts needs to be tapped, voluntarily or in required minimum distributions.



Individual investors usually have a majority, if not all, of their tax-sheltered retirement account investments in mutual funds. What is also common is to have additional retirement assets in mutual funds and other investments that are not in tax-sheltered retirement accounts, adding another level of complexity to your retirement withdrawal strategy.

Mutual funds by their structure make the withdrawal process easier, but do not eliminate all the challenges or automatically answer all your portfolio questions.

Additionally, IRS rules condition or limit your retirement withdrawal strategy. For example, you cannot withdraw money from your tax-sheltered retirement accounts before 59½ years of age without a 10% penalty, although there are exceptions to this rule.

And, you must start withdrawing funds—required minimum distributions (RMDs)—from your tax-sheltered retirement accounts once you reach the age of 70½, although there are again exceptions and detailed rules.

RMD Rules

Required minimum distributions are based on life expect-

tancy, and the IRS provides a uniform lifetime table in IRS Publication 590 that gives life expectancy factors as a function of age.

For example, if you are 70 years of age, your life expectancy is 27.4 years. As a simple example, if your total tax-sheltered retirement funds consist of one traditional IRA worth

\$100,000, then your first-year required minimum distribution would be \$100,000 divided by 27.4, or \$3,650. Of course, you could take more out, but remember that all withdrawals are taxable at ordinary income rates and not capital gains rates, so the longer you let the money remain in your retirement account, the longer that money can compound tax-free.

Every year your life expectancy changes, and your required minimum distribution changes, highlighting the fact that you can't read and study the IRS rules too much. Fortunately, mutual fund companies normally provide great assistance in doing the math for you and ensuring that you meet the IRS required minimum distribution rules completely.

But one IRS rule that affords important flexibility for your retirement withdrawal strategy and retirement portfolio management deals with situations where you have more than one retirement account. The rule applies to IRAs, including traditional, rollover and SEP, and also 403(b) plans. A simple example: You have only two IRAs, a traditional and a rollover, each with \$100,000; you are 70 years of age with an IRS life expectancy of 27.4 years and facing required minimum distribution time. You would be required to take a total of \$7,300 in the first year as a minimum distribu-

Table 1. Retirement Portfolio Example

Annual need: \$40,000
Assumptions: Age 70½
Minimize taxes

	Account Value	Required Minimum Distribution	Withdrawal Strategy
IRAs			
Rollover		\$6,569	
Small-Cap Fund	\$120,000		The total IRA required minimum distribution could come out of the emerging market fund to reduce the portfolio volatility. Portfolio will still be well-diversified.
Emerging Markets Fund	<u>60,000</u>		
	\$180,000		
SEP		\$4,380	
International Fund	\$80,000		
REIT Fund	<u>40,000</u>		
	\$120,000		
Total IRA RMD		\$10,949	
401(k)			
S&P 500 Index Fund	\$200,000		Distribution should come out of S&P 500 fund and bond fund equally to maintain diversification. Alternatively, roll 401(k) into the IRA and take entire distribution out of the emerging markets fund.
U.S. Gov't Bond Index Fund	<u>200,000</u>		
	\$400,000		
Other Retirement Investments		\$0	
Biotechnology Sector Fund	\$90,000		RMDs total \$25,548, which means \$14,452 must be withdrawn from these other retirement investments to meet annual income need (\$40,000 - \$25,548). This could be taken from the biotechnology fund and the tax-exempt income provided by the municipal bond and money market funds.
Tax-Exempt Muni Bond Fund	170,000		
Tax-Exempt Money Market Fund	<u>40,000</u>		
	\$300,000		
Total:	\$1,000,000		

tion from either or both IRAs in any configuration, as long as the total is \$7,300—useful flexibility for planning a withdrawal strategy and managing your total retirement portfolio. The same goes for 403(b) plans if you have more than one.

Unfortunately, the same rule does not apply to 401(k) plans. Are you surprised that IRS rules are this illogical? For each 401(k) plan you have, you must calculate and withdraw separate required minimum distributions—no flexibility for 401(k) plans.

Needless to say, this brief description is the simple version of these IRS retirement plan rules. For a more complete explanation, check the accompanying box for useful sources—and read them carefully.

Balancing Fund Withdrawals

How might all these tax rules affect your retirement withdrawal strategy options?

Let's use a mock-up of a mutual fund retirement portfolio as an illustration.

The example retirement portfolio in Table 1 is just that. What it isn't necessarily is a perfect portfolio for retirement. Think of this example portfolio as closer to an investor's average experience: accumulating investments over a lifetime of investing with some thought toward retiring and then arriving at retirement. [For more on how an "ideal" portfolio for withdrawals should be structured, see "Withdrawal Strategies to Make Your Nest Egg Last Longer"

starting on page 5 in this issue.]

As it turns out, this portfolio has a reasonable asset allocation for an average retirement portfolio—59% in stock and 41% in fixed income. Retirement portfolios with less than 50% of assets invested in stock risk erosion in value due to inflation and simply lack adequate growth for what may be a long retirement period, 20 years or more.

The portfolio is also relatively tax-efficient. One of the goals of this portfolio—or any portfolio—is to minimize taxes and to push the payment of any unavoidable taxes as far into the future as possible.

The other retirement investments—those investments not held in tax-sheltered accounts such as IRAs and 401(k) plans—minimize the gen-

eration of taxable ordinary income. The biotechnology sector fund does not provide income, but may produce capital gains subject to capital gains tax treatment. The municipal bond fund and the tax-exempt money market fund produce income not subject to federal income taxation.

However, keep in mind that all withdrawals from the IRA accounts and the 401(k) account will be taxed at federal and state ordinary income tax rates rather than at capital gains rates. Also, remember that while REIT funds produce significant dividend income, REIT dividends are generally not qualified for the lower 15% dividend taxation rate and make sense in the tax-sheltered SEP IRA account rather than being held in the taxable portion of this portfolio.

The assumptions used for managing this portfolio in retirement are:

- The annual pretax cash generation needed from the entire portfolio is \$40,000;
- Taxes should be minimized; and
- The individual owner of the portfolio has reached the age of 70½, trigger-

ing required minimum distributions from the tax-sheltered accounts.

In Table 1, the required minimum distribution given for each IRA account and the 401(k) account utilizes the first-year life expectancy rate of 27.4 years at age 70½.

For example: For the IRA rollover portfolio of \$180,000, the first-year required minimum distribution is \$6,569 (\$180,000 divided by 27.4 years).

The required minimum distributions from the two IRA accounts and the 401(k) account total \$25,548, which is \$14,452 less than the \$40,000 desired annually.

Calculated Withdrawals

Your first choice to make up this shortfall is to sell off assets in the taxable account, preserving the tax-sheltered accounts as long as possible. In other words, invade your tax-shelter minimally, no more than the total required minimum distributions.

The second choice is to select investments for required minimum distributions and taxable account invest-

ments to achieve or rebalance toward an appropriate portfolio allocation, considering risk, income and tax issues.

The two IRA accounts have a total required minimum distribution of \$10,949. This first-year distribution can be taken out of both IRAs in some combination, or all out of one.

In this case, taking the total distribution of \$10,949 out of the emerging market fund makes sense to reduce the volatility of the retirement portfolio. Emerging market funds often are less correlated with domestic small-cap and large-cap funds, but at times are highly correlated with international stock funds. However, without an emerging fund, this portfolio would still be well-diversified.

The 401(k) required minimum distribution of \$14,599 should come out of the S&P 500 index fund and the U.S. government bond index fund equally to maintain diversification. However, another alternative would be to roll the 401(k) plan over into a rollover IRA, assuming you no longer work for the 401(k) plan provider. This would allow you to take all of the \$25,548 out of the

Sources for IRS Rules on Retirement Plans

Internal Revenue Service

www.irs.gov

Search the Web site using keywords, or access the following publications:

Publication 590, IRAs (minimum distributions and life expectancy tables)

Publication 575, Pension and Annuity Income (for 401(k) minimum distribution rules and rollover rules)

Publication 560, Retirement Plans for Small Business (SEP, SIMPLE, and Qualified Plans)

Publication 571, Tax-Sheltered Annuity Plans (403(b) rules)

Publication 564, Mutual Fund Distributions (for calculating cost basis)

Mutual Fund Site Education Areas

Required minimum distribution rules, RMD calculator and planning tips

T. Rowe Price

www.troweprice.com

Vanguard

www.vanguard.com

emerging markets fund, preserving your investments in the low-cost portfolio core investments of the large-cap index and U.S. government bond index funds for a few more years.

If you do choose to do a rollover, be sure to contact your fund family or 401(k) provider to do an administrator-to-administrator rollover, avoiding any penalties.

The tax-exempt municipal bond fund will provide tax-exempt income throughout the life of the retirement portfolio, and the \$40,000 in the tax-exempt money market fund—while also providing tax-exempt income—serves as an emergency fund and is equal to about one year of cash needs. Given current interest rates, it is assumed that the tax-exempt municipal bond and money market funds produce total interest income of \$8,000 annually.

The \$6,452 remaining withdrawal (\$14,452 less the \$8,000 in muni bond and money market interest) should be taken from the biotechnology fund in the taxable account.

Using specific-share identification

rather than average net asset value cost basis (see IRS Publication 564, *Mutual Fund Distributions*), identify those shares with the highest cost basis to sell to generate the approximately \$6,500 in additional needed funds. If you have a gain, make sure the shares have been held for over a year.

Assuming you do not roll your 401(k) plan over into an IRA, the emerging markets fund as well as the biotechnology fund should last over a decade, assuming historical rates of return, but their depletion over time will decrease the stock representation in your portfolio.

But if your stock funds grow faster than your bond funds—your bond fund in your tax-sheltered account will grow due to reinvestment of interest—then you might be approaching a 50/50 stock/bond mix, the minimum investment in stocks you probably should maintain long term.

As you go forward into retirement, your goal should be to use the required minimum distributions and other withdrawals to maintain diversification and

a stock/bond allocation sufficient to provide both growth and reasonable stability of portfolio value.

“Safe” Withdrawals

The \$40,000 requirement was not just a sum plucked at random, but an amount that represents about 4% of the portfolio. Most research and simulation studies conclude that portfolios with annual withdrawal rates at 4% or less and greater than 50% in stock are most likely to last throughout retirement.

This simple example was designed to get you thinking about key issues in developing a retirement portfolio withdrawal strategy.

Unfortunately, the IRS rules are not quite so simple, so be sure to carefully read the IRS publications referenced in this article and contact your fund family for useful guidance and additional references on making retirement withdrawals from tax-sheltered accounts. And in retirement, don't forget to pay attention to your portfolio to stay diversified and to be tax smart. ▲

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